In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1628

NOVELART MANUFACTURING COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. A4-A39) is reported at 52 T.C. 794. The opinion of the court of appeals (Pet. App. A1-A3) is reported at 434 F. 2d 1011.

JURISDICTION

The judgment of the court of appeals was entered on November 27, 1970. A petition for rehearing was denied on January 25, 1971. The petition for a writ of certiorari was filed on April 24, 1971. The

jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether, in the circumstances, both courts below correctly held that petitioner was liable for the accumulated earnings tax imposed by Section 531 of the Internal Revenue Code.

2. Whether, in computing petitioner's accumulated taxable income subject to the Section 531 tax, both courts below correctly denied petitioner a deduction for premiums paid for key-man life insurance.

STATUTES AND REGULATIONS INVOLVED

Certain of the pertinent provisions of the Internal Revenue Code of 1954 are set forth in the petition (pp. 4-9). Additional statutory provisions and the pertinent provisions of the Treasury Regulations are set forth in the Appendix, *infra*, pp. 9-10.

STATEMENT

During the taxable years here in issue, those ended June 30, 1961, 1962 and 1963, petitioner had substantial investments in securities and real property. In its income tax returns for the years, it described the principal activity in which it was engaged as "Investments and Lessor of buildings." Its 80 percent-owned subsidiary was engaged in a lithographing, printing and binding business, in connection with which petitioner conducted some related research and development activities. Petitioner's sole stockholder was Charles H. Klein, to whom it paid annually

$42,000 in salary and $15,400 in dividends. (Pet. App. A5, A7, A19.)

At the beginning of fiscal 1961, petitioner's accumulated earnings and profits amounted to more than $4.7 million. Accumulated earnings and profits increased during the three years involved by $147,000, $125,000 and $85,000, respectively, and, at the end of fiscal 1963, exceeded $5.1 million. As of the beginning and end of each of the years, petitioner's liquid assets (consisting of cash, government obligations, stocks, bonds and other securities) were never less than $2.6 million, and its liabilities were never as much as $483,000. (Pet. App. A17-A18.)

The Commissioner of Internal Revenue asserted accumulated earnings tax deficiencies against petitioner on the ground that it had permitted its earnings and profits to accumulate beyond the reasonable needs of its business, for the purpose of avoiding the income tax with respect to its sole shareholder.[1] At trial in the Tax Court, petitioner contended that its substantial accumulations were needed to meet a variety of reasonably anticipated business needs. See Section 537, Appendix, *infra*, p. 9. After a careful review

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[1] The tax applies where the accumulation is for this purpose. Section 532(a), Appendix, *infra*, p. 9. An unreasonable accumulation is determinative of the proscribed purpose, "unless the corporation by the preponderance of the evidence shall prove to the contrary." Section 533(a), Appendix, *infra*, p. 9. A purpose to avoid shareholder income tax need be only one of the purposes of the accumulation in order for the tax to apply. *United States* v. *Donruss Co.*, 393 U.S. 297. Petitioner has not attempted to show that, if its accumulations were unreasonable, they were not for the purpose of avoiding shareholder income tax.

of the evidence (Pet. App. A29-A36), the Tax Court found that $782,000 was sufficient to meet such needs,[2] an amount substantially less than both petitioner's accumulated earnings and profits and its liquid assets at the beginning of fiscal 1961 and throughout the years in issue. It held that petitioner had unreasonably accumulated its earnings for each such year, had failed to show that this was not for the purpose of tax avoidance, and, therefore, was liable for the accumulated earnings tax imposed by Section 531 of the Internal Revenue Code. (Pet. App. A36-A37.)

Petitioner also contended that, in computing its accumulated taxable income subject to the Section 531 tax, it was entitled to deduct the premiums it paid for key-man life insurance. The Tax Court rejected this contention. It noted that such premiums are not deductible in computing taxable income pursuant to Section 264(a)(1). Since Section 535 (Pet. 6-9), to the extent here relevant, defines accumulated taxable income as taxable income with specified adjustments, and since key-man life insurance premiums are not among the adjustments specified, the court reasoned that there was no basis for allowing petitioner a deduction. (Pet. App. A38.)

On appeal, the Sixth Circuit held that the Tax Court's findings with regard to the unreasonableness of petitioner's accumulations were supported by sub-

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[2] In determining petitioner's reasonably anticipated business needs, the Tax Court included the business needs of petitioner's 80 percent-owned subsidiary as required by Treas. Reg. 1.537-3(b) (Pet. App. A27 n. 8).

stantial evidence. It also affirmed the lower court's holding on the computation of accumulated taxable income. Finally, it rejected petitioner's claim, made for the first time on appeal, that the tax imposed herein is unconstitutional. (Pet. App. A1-A3.)

ARGUMENT

The decision below is correct. There is no conflict or other reason for further review.

1. The principal question here is whether petitioner's accumulated earnings exceeded the reasonable needs of its business. Both courts below having concluded that petitioner's accumulations were unreasonably large, there is no basis for review by this Court of this essentially factual question. See *Comstock* v. *Group of Investors*, 335 U.S. 211, 214.

2. Petitioner's principal arguments center on the proposition that the reasonableness of an accumulation should be determined without regard to earnings accumulated as of the beginning of the taxable year. Thus, for example, petitioner contends that the courts below erred in holding, and finding relevant the fact, that petitioner's accumulation at the beginning of each taxable year exceeded its reasonably anticipated business needs for that year. The effect of doing so, petitioner maintains (Pet. 26-27), is to tax its prior accumulations retroactively, even though the statute of limitations for the prior years had run. There is no merit to these arguments.

In determining whether a corporation's earnings and profits for a taxable year exceed the reasonable needs of the business, "the amount of the earnings

and profits accumulated in prior years shall, of course, be taken into account." S.Rep. No. 1622, 83d Cong., 2d Sess., p. 317. If accumulated earnings of prior years are sufficient for the reasonable needs of the business, then any accumulation of earnings for the taxable year is unreasonable. Treasury Regulations on Income Tax (1954 Code), Section 1.535-3 (b)(1), Appendix, *infra*, p. 10. This is so at least to the extent that accumulated earnings are reflected in liquid assets. *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F. 2d 495, 500-501 (C.A. 4), certiorari denied, 362 U.S. 976.

The effect of taking prior years' accumulations into account is not to tax those accumulations as petitioner claims. This is made clear by the instant case itself. Although petitioner's accumulated earnings and liquid assets at the beginning of fiscal 1961, $4.7 million and $3 million, respectively, each exceeded its reasonable business needs for that year of $782,000, no tax was imposed on either excess amount. As petitioner's own table shows (Pet. 15), the tax was levied only on its additional accumulation for that fiscal year, computed in accordance with the provisions of Section 535. The same holds true for the later taxable years.

3. Petitioner's remaining contentions do not merit extended discussion. Its constitutional argument (Pet. 32-38) is inconsistent with this Court's decision more than 30 years ago in *Helvering* v. *Northwest Steel Mills*, 311 U.S. 46. Its argument regarding the treatment of key-man insurance premiums (Pet. 27-32) was fully answered in the opinions of the Tax Court (Pet. App. A37-A38) and the court of appeals (Pet.

App. A3) on which we here rely. As for its claim that interest does not begin to run on an accumulated earnings tax deficiency until after notice and demand therefor (Pet. 25-26), this was not raised in either court below and, accordingly, is not properly before this Court. At all events, the claim is premature. No interest has yet been assessed, nor was the interest question one that could have been resolved by the Tax Court in the proceedings below. The date from which interest is to run is "not within the issues before the Tax Court since such interest can only be determined after a final judgment in the deficiency proceeding * * *." *Transport Mfg. & Equipment Co.* v. *Commissioner*, 434 F.2d 373, 382 (C.A. 8). No such judgment has yet been entered here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1971.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * *

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

* * * *

SEC. 537. REASONABLE NEEDS OF THE BUSINESS.

For the purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

SEC. 1.535-3 *Accumulated earnings credit.*

* * * *

(b) *Corporation which is not a mere holding or investment company*—(1) General rule. * * *

(ii) In determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business, the accumulated earnings and profits of prior years will be taken into consideration. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business. See section 537 and §§ 1.537-1 and 1.537-2.

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